



**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH
REQUIREMENTS APPLICABLE TO EACH MAJOR PROGRAM AND INTERNAL
CONTROL OVER COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133**

Board of Education
San Francisco Unified School District
San Francisco, California

Compliance

We have audited the compliance of San Francisco Unified School District with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major Federal programs for the year ended June 30, 2004. San Francisco Unified School District's major Federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major Federal programs is the responsibility of San Francisco Unified School District's management. Our responsibility is to express an opinion on San Francisco Unified School District's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major Federal program occurred. An audit includes examining, on a test basis, evidence about San Francisco Unified School District's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of San Francisco Unified School District's compliance with those requirements.

In our opinion, San Francisco Unified School District complied, in all material respects, with the requirements referred to above that are applicable to each of its major Federal programs for the year ended June 30, 2004.

Internal Control Over Compliance

The management of San Francisco Unified School District is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to Federal programs. In planning and performing our audit, we considered San Francisco Unified School District's internal control over compliance with requirements that could have a direct and material effect on a major Federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major Federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the Board of Education, management, the California Department of Education, the State Controller's Office, Federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Varrinck Trine Day & Co. LLP

San Jose, California
January 18, 2005



INDEPENDENT AUDITORS' REPORT ON STATE COMPLIANCE

Board of Education
San Francisco Unified School District
San Francisco, California

We have audited the financial statements of the San Francisco Unified School District as of and for the year ended June 30, 2004, and have issued our report thereon dated January 18, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial and compliance audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the State Controller's *Standards and Procedures for Audits of California K-12 Local Educational Agencies*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The management of San Francisco Unified School District is responsible for the District's compliance with laws and regulations. In connection with the audit referred to above, we selected and tested transactions and records to determine the San Francisco Unified School District's compliance with the State laws and regulations applicable to the following items:

	Procedures in Controller's Audit Guide	Procedures Performed
Attendance accounting		
Attendance reporting	6	Yes
Kindergarten continuance	3	Yes
Independent study	22	Yes
Continuation education	10	Yes
Adult education	9	Not applicable
Regional occupational centers and programs	6	Yes
Instructional time and staff development reform program	7	Yes
Instructional Time:		
School districts	4	Yes
County Offices of Education	3	Not applicable
Community day schools	9	Yes
Class size reduction program:		
General requirements	7	Yes
Option one classes	3	Yes
Option two classes	4	Not applicable
District or charter schools with only one school servicing K-3	4	Not applicable

Instructional Materials:

General requirements	9	Yes
K-8 only	1	Yes
9-12 only	1	Yes
<i>Ratios of Administrative Employees to Teachers</i>	1	Yes
Early retirement incentive	4	Not applicable
GANN limit calculation	1	Yes
Office of Criminal Justice Planning	-	Yes

Based on our audit, we found that for the items tested, the San Francisco Unified School District complied with the State laws and regulations referred to above. Further, based on our audit, for items not tested, nothing came to our attention to indicate that the San Francisco Unified School District had not complied with the laws and regulations.

This report is intended solely for the information and use of the Board of Education, management, the California Department of Education, the State Controller's Office, Federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Varrinek Trine Day & Co. LLP

San Jose, California
January 18, 2005

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

SAN FRANCISCO UNIFIED SCHOOL DISTRICT

SUMMARY OF AUDITORS' RESULTS FOR THE YEAR ENDED JUNE 30, 2004

FINANCIAL STATEMENTS

Type of auditors' report issued:	<u>Unqualified</u>
Internal control over financial reporting:	
Material weaknesses identified?	<u>No</u>
Reporting conditions identified not considered to be material weaknesses?	<u>Yes</u>
Noncompliance material to financial statements noted?	<u>No</u>

FEDERAL AWARDS

Internal control over major programs:	
Material weaknesses identified?	<u>No</u>
Reporting conditions identified not considered to be material weaknesses?	<u>None reported</u>
Type of auditors' report issued on compliance for major programs:	<u>Unqualified</u>
Any audit findings disclosed that are required to be reported in accordance with Circular A-133, Section .510(a)	
Identification of major programs:	<u>No</u>

<u>CFDA Number(s)</u>	<u>Name of Federal Program or Cluster</u>
<u>93.596</u>	<u>Federal Child Care, Center Based</u>
<u>84.010</u>	<u>Title I</u>
<u>10.555</u>	<u>Child Nutrition Cluster</u>
<u> </u>	<u> </u>
<u> </u>	<u> </u>
<u> </u>	<u> </u>

Dollar threshold used to distinguish between Type A and Type B programs:	<u>\$ 2,774,787</u>
Auditee qualified as low-risk auditee?	<u>No</u>

STATE AWARDS

Internal control over state programs:	
Material weaknesses identified?	<u>No</u>
Reporting conditions identified not considered to be material weaknesses?	<u>None reported</u>
Type of auditors' report issued on compliance for state programs:	<u>Unqualified</u>

SAN FRANCISCO UNIFIED SCHOOL DISTRICT

FINANCIAL STATEMENT FINDINGS FOR THE YEAR ENDED JUNE 30, 2004

The following findings represent reportable conditions, material weaknesses, and/or instances of noncompliance related to the financial statements that are required to be reported in accordance with *Government Auditing Standards*. The findings have been coded as follows:

<u>Five Digit Code</u>	<u>AB 3627 Finding Type</u>
60000	Miscellaneous

2004-1 Maintenance of Adequate Reserves (60000)

Criteria or specific requirements

The District must maintain its fiscal solvency as measured by its available reserves. The minimum recommended reserve level for a District this size is 1% of its total general fund expenditures and transfers out, or approximately \$4.74 million, for the fiscal year ended June 30, 2004. The District must move to restore this reserve level to 2% of total general fund expenditures and transfers out by the end of the 2005-06 fiscal year.

Condition

After adjusting for the impact of prior period adjustments, the District began the year with approximately \$4.6 million in available reserves. During the 2003-04 fiscal year, the District has continued its pattern of deficit spending. Referring to the District's general fund statement of revenues and expenditures for the year ended June 30, 2004, after backing out the impact of significant one-time monies resulting from the SRS settlement, and factoring in the impact of the current year revenue limit adjustment (See Note 8 to the financial statements) which has been reclassified as a component of long-term debt, and other adjustments, the District deficit spent in the unrestricted general fund by approximately \$17.77 million. As a result, the District is showing negative available reserves as of June 30, 2004, of approximately \$6.9 million. This number does not include any impact from the State financed revenue limit adjustment of \$10.05 million (which would further increase the negative reserve balance), nor does it take into consideration the deferral of the one-time settlement proceeds of the SRS lawsuit settlement of \$16 million (which would increase the available reserves).

Effect

The continued pattern of deficit spending has caused the District to report an unrestricted deficit in available reserves of \$6.9 million at June 30, 2004. The recognition of the balance of the SRS settlement proceeds in the 2004-05 fiscal year will restore some of the District's reserves but that alone will not be sufficient as the District must commit itself to a plan of significant expenditure reductions to restore its reserves.

Cause

The State of California is continuing to take steps to balance its own State budget and all areas of government, including local education agencies are feeling the impact of State reduced revenues.

Dramatic increases in the costs of fringe benefits for active employees as well as retirees represent the District's most significant source of expenditure-related fiscal pressure.

SAN FRANCISCO UNIFIED SCHOOL DISTRICT

FINANCIAL STATEMENT FINDINGS FOR THE YEAR ENDED JUNE 30, 2004

The District also continues to decline in enrollment which, in turn, reduces revenue limit funding. In addition, the continued proliferation of charter schools, because of the nuances of the State's revenue limit formula, actually cost the District monies because the District receives revenue for its Charter School ADA at one rate but has to pay out funds to the Charter at a higher rate as mandated by the State's funding formula.

Recommendation

The District needs to reverse its recent pattern of deficit spending. All areas of spending need to be reviewed. Without new sources of significant revenue, significant spending cuts will be necessary to maintain the District's fund balance and restore its undesignated fund balance to 2%, as required beginning in FY 2005-06.

District Response

District management concurs with the finding and the recommendation to achieve expenditure reductions. The District is currently investigating and/or implementing a variety of cost-cutting strategies, including closure and consolidation of some schools, negotiating collective bargaining provisions to reduce fringe benefits costs, implementing hiring freezes, reducing central office staff, furloughs and reductions in all discretionary budgets. Additionally, the District is working with its Special Education and Child Development program managers to determine how spending levels in these areas can be decreased.

However, the District must clarify that although these financial statements indicate a negative position for its unrestricted, undesignated reserve balance, this does not include the impact of \$16.05 million of revenue from the settlement of the lawsuit described above, which was executed during the 2003-04 fiscal year. Had this remaining amount been recognized, the District's unrestricted, undesignated ending fund balance would have been \$8,699,694, or 1.87% of its total General Fund expenditures and other uses (compared to the state requirement for similarly sized school districts of 1%). Notwithstanding this clarification, the District does recognize the need to reduce ongoing expenditures in the future.

2004-2 Revenue Limit Accounting and Monitoring (60000)

Criteria or specific requirements

Revenue Limit is the single largest revenue source for the District and the intricacies of the calculation need to be understood and monitored by District personnel both for budgetary considerations as well as financial reporting considerations. Calculation of the proper revenue limit and the subsequent adjustments required to reconcile the computed amount to the District's financial records is essential.

Condition

Significant audit adjustments were made to properly calculate, reconcile and report the revenue limit accurately in the District's financial statements, both for the General Fund (Fund 01) as well as the County School Service Fund (Fund 05). Furthermore, the District was unaware of the net \$10 million shortfall in the general fund revenue limit (See Note 8) until it was brought to their attention by the auditors.

**FINANCIAL STATEMENT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2004**

Effect

Audit adjustments and significant additional auditor staff time were necessary to recalculate the revenue limit for both Fund 01 and 05.

Cause

The revenue limit calculation for the District is complex and does encompass issues that are not generally a concern for other school districts:

- The District has a number of charter schools and is experiencing declining enrollment. Those factors impact the amount of revenue limit ADA to be reported.
- The District is allocated a significant amount of ERAF taxes, more than they can actually use. This condition causes the District to fall into the negative State Aid situation as noted above because they cannot use all the ERAF taxes allocated to them. This causes amounts to be transferred between Fund 01 and Fund 05, and there is a correspondent need to constantly monitor that situation.

Recommendation

The District needs to designate at least one person as the lead individual responsible for monitoring the revenue limit and making all year end calculations and resultant adjustments. It should be that person's responsibility to ensure that all revenue limit projections and year-end calculations are correct and the financial statements properly reflect the impact of any and all required adjustments. We recommend that the designated person be given the training necessary to become proficient in the way that revenue limits are calculated, paying particular attention to the issues that directly impact the District. In addition, we believe that personnel in an oversight capacity, namely the Director of Fiscal Services and the CFO, attend the same training or even additional training so that they will be able to properly review the work in this area and provide adequate oversight.

District Response

District management concurs with the finding and the recommendation to more precisely calculate and validate revenue limit funding. The District has recently hired a highly qualified Budget Director who has over twenty years of experience in California school finance in school districts as well as county offices of education. This individual is very familiar with revenue limit calculations and will be primarily responsible for such calculations in the future.

SAN FRANCISCO UNIFIED SCHOOL DISTRICT

**FEDERAL AWARDS FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED JUNE 30, 2004**

There were no findings that represent reportable conditions, material weaknesses, and/or instances of noncompliance including questioned costs that are required to be reported by OMB Circular A-133.

SAN FRANCISCO UNIFIED SCHOOL DISTRICT

**STATE AWARDS FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED JUNE 30, 2004**

There were no findings that represent instances of noncompliance and questioned costs relating to state program laws and regulations.

SAN FRANCISCO UNIFIED SCHOOL DISTRICT

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS FOR THE YEAR ENDED JUNE 30, 2004

Except as specified in previous sections of this report, summarized below is the current status of all audit findings reported in the prior year's schedule of financial statement findings.

Financial Statement Findings

2003-1 Categorical Program Accounting (30000)

Criteria or specific requirements

Federal and State categorical program accounting is a significant accounting process which needs to be properly processed and supervised in order for the District's financial statements to be accurately and timely prepared.

Condition

We again noted this year that the accounting for these programs was substandard. During FY 2002-03 the District engaged additional resources through an independent contractor to improve the state and federal program accounting function. Unfortunately, the personnel primarily responsible for this area still lack the required expertise to discharge their responsibilities, and management oversight did not sufficiently correct for shortcomings in this important accounting function. Specifically we noted the following:

- Material audit adjustments in excess of \$10 million due to errors in the final program accounting report.
- Incorrect receivable and deferred revenue accruals.
- Initial charges of program benefit costs to the unrestricted general fund rather than to restricted programs (corrected during the closing process).
- Insufficient analysis of revenues and/or expenditures by program.
- Insufficient communication between program accounting personnel and site program personnel.

Effect

- Significant additional audit time and cost was incurred.
- Inaccurate District-prepared financial reports
- There were additional delays in finalizing the year-end audit.
- Delays and challenges in preparing accurate financial information for the District as a whole will recur unless the problem is corrected.

Cause

- Lack of qualified personnel to perform the necessary tasks.
- Insufficient supervision by management.

**SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2004**

Recommendation

The District needs to recruit sufficient qualified personnel to both process and supervise the accounting for categorical programs. Specifically, the District needs to hire a qualified person to supervise this function. We believe this individual should report directly to the Chief Business Officer

Current Status

Implemented.

The District underwent a year-long review of the accounting for categorical programs and has largely mitigated the problems noted in the prior year audit. Categorical program balances were readily auditable this year with sufficient backup to support the ending balances. The District has employed outside consultants to review the accounting for each program and that effort has resulted in a significant improvement in the accounting and control over these programs. The District has also hired an individual to take over the day to day accounting for these programs and is currently being trained and monitored by the outside consultant. We applaud the District for their efforts in correcting this problem.

2003-2 Maintenance of Adequate Reserves (60000)

Criteria or specific requirements

The District must maintain its fiscal solvency, as measured by its available reserves, in light of the State's ongoing fiscal crisis.

Condition

The District began the fiscal year with approximately \$26.2 million in available reserves, but ended the fiscal year with approximately \$8.6 million. The District deficit spent in the unrestricted general fund by approximately \$31.4 million.

The District was able to 1) make one-time shifts from the restricted to the unrestricted general fund of approximately \$10.1 million and 2) restore \$3.7 million in fund balance from a residual equity transfer from the Self-Insurance fund in order to achieve the year end available reserve amount.

Operating cost increases from step and column salary adjustments, significant increases in employee benefits and an increase in special education encroachment account for much of the increase in the current-year operating deficit. As reported in the prior year, the District deficit spent by approximately \$18.1 million in fiscal 2002.

Effect

Continued deficit spending will eventually exhaust the District's unrestricted reserves.

SAN FRANCISCO UNIFIED SCHOOL DISTRICT

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS FOR THE YEAR ENDED JUNE 30, 2004

Cause

- The State's fiscal crisis and the condition of the local economy have created significant financial pressure on the District due to stagnant or declining revenue sources during FY 2002-03.
- The District is continuing to decline in enrollment which, in turn, has a negative impact on revenues. At the same time costs of operation continue to increase, particularly in the areas of employee benefits and special education encroachment.
- The District did not have a Chief Business Officer or a Director of Budget during the last quarter of the last fiscal year. The transition between the previous and current Chief Business Officer and Director of Budget raised additional challenges to the District's ability to monitor financial activity during a portion of the fiscal year.

Recommendation

The District needs to continue efforts to reverse its current pattern of deficit spending. As such significant budget cuts initiated in 2003-04 will be required for succeeding years.

This matter has been discussed with District management. In addition to closing numerous positions and reducing non-personnel budgets within the past year, District management believes there are additional areas where cuts can and will be made. In this light, the District must develop specific expenditure reduction plans to maintain reserves at an acceptable level. The District must continue to pay particular attention to the significant increases in special education encroachment.

Current Status

Not implemented, see current year finding 2004-1

2003-3 Year-End Closing Procedures (60000)

Criteria or specific requirements

The District needs to be able close its books and produce accurate Unaudited Actuals in time to meet state timelines and to allow for the annual audit to be completed by the December 15th deadline.

Condition

The District has been late with the filing of its Unaudited Actuals for several years and has been late with the filing of its annual audit report for the past two years. In addition, the Unaudited reports, once filed, have proven to be inaccurate, requiring additional analysis and audit costs to the District plus an atypical degree of auditor-generated adjustments.

Effect

The District has a responsibility to be timely and accurate in its financial reporting. Late and inaccurate reporting increases the risk that financial problems may not be detected in time for corrective action to be taken.

**SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2004**

Cause

Issues previously noted with respect to the accounting for categorical programs are a prime factor in the District's ability to report its annual results in a timely manner. The District has also lacked sufficient discipline in ensuring that timelines are established and adhered to.

Recommendation

The Chief Business Officer, in conjunction with business office staff, must set specific timelines for closing procedures for the 2003-04 fiscal year. The Director of Fiscal Services should be given the direct responsibility for ensuring that timelines are met. Timelines must be set for such items as receivable and payable accruals, cash reconciliations, post closing adjustments, federal and state categorical revenues and expenses reconciliation, GASB 34 conversion entries and entity-wide financial statement presentation and preparation and delivery of the year-end Unaudited Actuals to the State.

In conjunction with the closing process, the Chief Business Officer must set up procedures to review, in detail, the resultant year-end amounts, including the applicable backup documentation, in order to ensure both the timeliness and the accuracy of the end product.

Current Status

Partially implemented. See current year finding 2004-2.
The District was again late with the filing of its unaudited actuals for the year ended June 30, 2004. This was largely the result of the effort put into correcting the categorical program balances which required significant time and effort to complete. But for the need to go through this extensive review of categorical programs, the unaudited actuals would have been filed on time. However, we still noted significant revenue limit adjustments that should be caught in the normal closing process. See current year revenue limit finding.

SAN FRANCISCO UNIFIED SCHOOL DISTRICT

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS FOR THE YEAR ENDED JUNE 30, 2004

Federal Award Findings

2003-4 Condition (50000)

Per OMB Circular A-87 Local Education Agencies (LEA's) must have employee certifications of their assignments to Federal programs. For employees funded by one federal program, a semi-annual certification must be completed by the employee and retained by the District. For multi-funded employees, activity reports must be maintained to support the charges made to Federal programs. We performed alternative test procedures and we are satisfied that payroll charges made to the major Federal programs selected for testing are correct. The District, however, does not maintain these required employee certifications.

Recommendation

The District needs to implement policies and procedures that require federally funded employees to prepare the appropriate documentation to support their payroll charges to federal programs in accordance with the provisions of OMB Circular A-87.

Current Status

Implemented.

State Award Findings

There were no prior year findings.